



# Properly Pricing Your Products and Services



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## Introduction

Properly pricing products and services is a key factor in a credit union's financial strength and member satisfaction. Credit union management must plan to strike the proper balance between these two competing needs. It can be tricky. There are no universal, one-size-fits-all methods. In this publication, we examine the following pricing topics to assist credit union management with creating the proper balance:

- I. Loan and Share Pricing,
- II. Risk-Based Loan Pricing Net Yield Analysis, and
- III. Product Cost Accounting.

## I. Loan and Share Pricing

Credit unions use various models to price share and loan products. We will discuss the following:

- Look Over the Fence
- Modified Look Over the Fence for Dividends
- Price Leadership
- Cost + Pricing Models

**Look Over the Fence** – This model surveys the competition and prices products and services somewhere within your market's range to achieve a certain market position. An example would be always setting loan rates near the local market average and dividend rates above the market average. Then at the end of the accounting period, you find out if the strategy worked. This model's chief advantage is simplicity. Disadvantages are that it delegates control of the credit union's pricing to other institutions that may or may not have the same product and service offerings to support. Moreover, incorrect pricing may take some time to show up in negative operating results. By that time, errors can be more difficult to correct as some rates may be locked in for long terms.

**Modified Look Over the Fence for Dividends** – Systematic alternatives to the Look Over the Fence model to set dividend rates are rare. But most credit unions only use that as a starting point for setting dividend rates. Adjustments are made at the discretion of management considering internal conditions such as:

- Profitability – Regardless of market rates, the credit union must set its dividend rates to maintain long-term profitability.
- Liquidity – What is the credit unions liquidity position? Higher dividend rates encourage share growth (increasing liquidity), while lower rates discourage share growth (decreasing liquidity).
- Net Worth – The higher share growth generated by high dividends can dilute the credit union's net worth. Can the credit union afford this?

**Price Leadership** – This is a version of Look Over the Fence in which dividend rates are always set above those of your competitors and loan rates and fees are always set below. In the long run, it is only effective if you have a competitive advantage over the rest of your market in terms of factors like capitalization and cost structure. Higher capitalization, lower cost structure, or other competitive financial advantages will allow you to bring in new shares attracted by above-market rates and sacrifice yield by offering below-market loan rates without diluting net worth and earnings.



**Cost + Pricing Models** – This is a loan pricing method. It assumes the interest rates charged for loans should include four components:

- The funding costs incurred to obtain the money loaned. For credit unions, this is usually the dividend rate used to attract shares, but it could include borrowing costs;
- The costs of making and servicing the loan;
- A risk premium to compensate for the estimated loan losses or credit risk; and
- A profit margin providing an adequate return on capital.

Let's consider a practical example of how Cost + Pricing determines the interest rate on a loan request of \$10,000:

The credit union obtains funds to lend at a cost of 0.5 percent (the dividend rate.) Overhead costs for servicing the loan are estimated at 1.0 percent of the requested loan amount and a premium of 1.0 percent is added to compensate the credit union for credit risk, or the risk that the loan will not be repaid on time or in full. The credit union has determined that all loans will be assessed a 1.0 percent profit margin over and above the financial, operating, and risk-related costs. Adding these four components, the loan request can be extended at a rate of 3.5 percent (0.5 percent cost of funds + 1 percent operating costs + 1 percent default risk + 1 percent target profit margin). If the assumptions are correct, the credit union can make a 1 percent return on every dollar loaned.<sup>1</sup>

The advantage of Cost + Pricing is that it guarantees every loan will be profitable, assuming the credit union has accurate information and can correctly apply it.

There are numerous disadvantages:

1. The components of the calculation can be difficult to measure and apply. Your accounting and data processing systems may not be able to easily produce the required information.
2. It ignores the market. If the analysis results in non-competitive pricing, it is of limited use.
3. Challenges in determining the correct cost of funds. Should this be the average cost of funds (available on the Financial Performance Report) or some other measure?
  - a. If liquidity is high, should cost of funds be considered 0 percent? Have you really incurred extra costs to attract loan funds if you have excessive cash balances?
  - b. If liquidity is very low, should the cost of funds be the marginal cost associated with actually attracting the extra loan funds?
  - c. Should investment returns or market rates be used in place of cost of funds? Changes to the cost of funds tends to lag the market, while investment yield does not. Therefore investment yields might more accurately capture opportunity costs.
4. It does not compensate for interest rate risk. Higher rates for longer term loans can offset this risk.

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<sup>1</sup> Mathew D. Diette, "How do Lenders set Interest Rates on Loans", Federal Reserve Bank of Minneapolis Community Dividend, November 1, 2000, Accessed February 13, 2017, <https://www.minneapolisfed.org/publications/community-dividend/how-do-lenders-set-interest-rates-on-loans>



Cost + Pricing also presents difficulties in measuring the costs of making the loan. For example, should this include all operating costs—such as overhead, salaries, benefits, office occupancy and office operations—or just incremental costs, like specific filing fees or origination costs? If the overhead costs cannot be changed in the short run, are you better off ignoring them? Should loan size be considered? It depends on how important fixed costs are (it costs the same to file the mortgage for a \$5,000 loan as for a \$250,000 loan). Or should the costs just be averaged?

Consider two identical home equity loans except for the amount:

| Comparative Yield – Large vs. Small Loans |         |           |
|---|---------|-----------|
| Loan Amount                               | \$5,000 | \$250,000 |
| Interest Rate                             | 5.00%   | 5.00%     |
| Interest for Five Year Term               | \$625   | \$31,250  |
| Closing Costs Paid by Credit Union        | \$500   | \$500     |
| Net Income after Closing Costs            | \$125   | \$30,750  |
| Average Annual Loan Yield                 | 1.26%   | 4.91%     |

Should the difference be accounted for in pricing of different sized loans?

After the loan pricing decisions are made, compare the loan yields to a risk-free investment at a similar term. The loan yield should always be better. If the loan yield is not better, you could increase income by making the risk-free investment.

**Loan and Share Pricing Conclusion** - No matter what loan and share pricing methods are used, you also need to consider:

- The competitive market – A little “looking over the fence” is still necessary;
- Member benefits and expectations – Pricing is part of the credit union’s existing brand;
- Profitability and net worth – Pricing has a major impact on these key financial goals and should be fully integrated into the budgeting process;
- Interest rate risk – Pricing policies can affect this risk; and
- Relationship Pricing (bundling) – While most pricing methodologies focus on individual products, pricing some products at a loss (loss leaders) can be effective in getting members to adopt other more profitable products.

## II. Risk-Based Loan Pricing Net Yield Analysis

Risk-based lending is setting a tiered pricing structure that assigns loan rates based upon an individual’s credit risk. Through a carefully planned risk-based lending program, credit unions may be able to make loans to higher-risk borrowers, as well as better serve their more credit-worthy members. Risk-based lending has surged in popularity. Only three percent of all federally insured credit unions reported risk-based lending on the December 31, 2004, call report. Twelve years later, that number had increased to 71 percent.



#### Advantages of Risk-Based Lending:

- Provides service to a greater number of members (including those with limited economic means);
- Enhances the ability to offer individualized service and credit counseling;
- Allows marginal borrowers to improve credit-worthiness and credit history;
- Increases ability to cross-sell and extend service relationships;
- Improves the credit union's image;
- Improves the credit union's competitive advantage;
- Increases loan volume;
- Improves asset diversification;
- Increases income to cover higher costs associated with greater risks (if loans are correctly priced); and
- Promotes management of risk, versus minimization of risk.

#### Possible disadvantages:

- Requires significant training and education of credit union officials, management, staff, and members;
- Requires restructuring of lending policies;
- Requires maintenance and periodic re-evaluation (validation of criteria);
- Increases consumer compliance issues;
- May result in increased delinquency, loan losses, collection costs; and
- May reduce liquidity.

Below are additional links to risk-based lending resources:

- [NCUA Letter to Credit Unions 174, Risk-based Lending Whitepaper](#)
- [NCUA Letter Credit Unions, 99-CU-05, Risk-Based Lending](#)
- [OSCU's Resource Guide, Serving the Credit Invisibles](#)

To ensure appropriate risk-based loan pricing, management will want to periodically monitor the net yield of their risk-based loans. In the Resources section, you will find a spread sheet (RBP Loan rate Analysis.xlsx) with a simple example of tracking net yields on risk-priced loans. Your data processor or staff will need to be able to track income, expenses, delinquency, and losses by credit grade so you can continually monitor the program and determine correct pricing. Gathering this data is critical. Management should start accumulating the data as soon as it contemplates adopting risk-based pricing. If you are already risk-based pricing and aren't gathering this data, start now.

### III. Product Cost Accounting

Product cost accounting is a set of procedures for determining the income and costs attributable to providing a specific product or service. Key components are:

- Direct income,
- Direct costs – fixed and variable,
- Cost of funds, and
- Indirect costs (overhead) - fixed and variable.



Included in the resources section of this guide is a spreadsheet (Cost Acct Services.xls) with sample cost accounting worksheets for various products.

In analyzing product profitability consider the following:

- What should target profitability be? Do the products need to contribute a specific amount to Return on Average Assets? Or is it acceptable as long as the return is greater than the return on investments (opportunity costs)?
- Do all products need to be profitable or are some products acceptable as loss leaders? Many modern digital services are loss leaders—such as home banking or bill pay—and if you charge fees to make them profitable, members may not want to use them.
- Product unprofitability may be caused by many factors:
  - Fees that are too low
  - Costs that are too high
  - Low volume insufficient to offset fixed costs

If your analysis shows certain products are unprofitable, use this information to specifically target expense reductions, fee increases, or volume increases to improve product profitability.

- If the credit union is highly liquid, is it appropriate to charge cost of funds to products? Do the funding costs truly cease if you discontinue the product?
- Are the indirect (overhead) cost estimates appropriate? If you discontinued the program would you truly be able to cut these expenses?

## IV. Conclusion

Product pricing is a critically important decision for credit union management. By using these and other methodologies management can make a more rational decision on where to set the dial in the tradeoff between profitability and member satisfaction.

## Resources

For additional resources go to <https://www.ncua.gov/services/Pages/small-credit-union-initiatives/Documents/product-pricing-guide-resources.zip>



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